November 6, 2003

Mr. Paul Knueven
Minerals Management Service
Minerals Revenue Management
Records and Information Management Team
P.O. Box 25165, MS 320B2
Denver, CO 80225-0165

Dear Mr. Knueven:

The State of Wyoming offers the following comments to the August 20, 2003 proposed rule on federal oil valuation, 68 Fed. Reg. 50087. Because we agree with the Minerals Management Service that "the oil rule is working well and accomplishing its objective," we see no need to revise the current rule. However, if the MMS does revise the current rule, it should limit those revisions to the use of NYMEX based valuation. Specific comments on each issue raised by the proposed rule are set forth below.

NYMEX Based Valuation

The MMS's proposal to change from spot price valuation to a NYMEX based valuation for non-arm's length sales is important and appropriate. However, NYMEX should be used for valuing all crude oil, when the use of an index is appropriate. We do not agree with the exception for the Rocky Mountain Region in which MMS proposes to use NYMEX as the revised third benchmark (proposed to be redesignated as section 206.103(b)(3)).

NYMEX numbers drive the oil and gas marketplace worldwide, so there is not a better starting point for value in any region. The MMS acknowledged this fact in its preamble regarding the changes contemplated. NYMEX is widely referenced by traders and representatives, and is more reflective of the market than spot prices. Moreover, NYMEX is objectively verifiable and less susceptible to the type of manipulation we have observed with price surveys. We agree NYMEX based valuation would be simplified by using the calendar month rather than the trading month.

Finally, we would request that MMS share with the affected states the results of its study that concluded NYMEX represents the public indicia with the closest correlation to arms-length crude oil pricing mechanisms.

Adjusting the NYMEX Price for Location and Quality Differentials

The MMS proposes using location and quality differentials to adjust the difference between various grades of oil in the Rockies when using NYMEX prices. These location and quality differentials depend upon spot prices when companies do not exchange oil at arm's-length between points in the Rockies to Cushing, OK. MMS is adopting a NYMEX based valuation method because it is "more reliable and a better assessment of current oil values than spot prices." Why, then, is MMS willing to use unreliable spot prices, which are known to be susceptible to manipulation, to establish location and quality differentials? MMS should only allow actual location and quality differential deductions, not hypothetical deductions.

Allowable Transportation Cost Deductions

The current regulations under C.F.R. §206.110 and §206.111 establish the allowable transportation cost deductions. No changes to these regulations are warranted. The CFR adequately defines such costs and covers all necessary and appropriate cost deductions. MMS should not allow any indirect deductions for transportation. Arm's-length transportation costs should only be allowed if they are reasonable and actually incurred.

MMS's proposal to expand transportation deductions amounts largely to re-labeling marketing costs as transportation costs. MMS has a long-standing policy of not allowing either direct or indirect marketing costs. Payments to quality bank administrators and costs related to line fill, short-term storage and creditworthiness do not add value to the product. They represent costs necessary to assure business commitments, i.e., to get the product into the marketplace, and therefore should not be deductible. Permitting a deduction for line loss is patently contrary to the historic practice of determining royalty volume at the lease. Finally, the proposed expansion of transportation cost deductions will inevitably lead to litigation. Any additional future litigation will unnecessarily complicate, not streamline audit procedures. We see no legitimate reason to change current detailed transportation allowances.

Valuation of Sour Crude

The MMS proposes to value sour crude produced in the Rockies based on a spot market price in Hardisty, Alberta, Canada, with an adjustment for transportation from the lease to Casper, and another transportation adjustment from Casper to Hardisty. Hardisty is a distant, foreign market (Canada). In Canada, oil is measured by the metric system and therefore requires a conversion to barrels. A currency conversion is also necessary. The US-Canadian currency conversion rate changes daily and the information can be hard to obtain. Using the Hardisty market center would be difficult and prone to errors. Hardisty is no more applicable to Wyoming leases than Cushing, OK. Accordingly, it would be more appropriate to use a NYMEX price less a location/quality differential for Wyoming sour crude. In these cases, the producer should consult directly with the State and MMS on proper valuation.

Rate of Return

Return on investment should be struck from the proposed rule. The vertically integrated members of industry elected to invest in pipelines in order to pursue an economic opportunity. This investment is rewarded in the U.S. Internal Revenue tax code from the standpoint of depreciation deductibility, without the benefit of a return on invested capital. Transportation deductions against royalty payments afford this same reward today. The movement of production from a lease has always been an integral part of the business. Royalty interests should not be diminished further by allowing return on investment guarantees. However, if a guarantee is ultimately allowed, MMS should publish the research used to support the allowance.

The MMS proposes to allow industry to increase the rate of return for determining transportation allowances from Standard Poor's BBB bond rating to 1.5 times the BBB. Industry's efforts to increase the rate of return were rejected during 1988 and 2000 rulemaking. At that time, MMS explained that the junk bond rate "is higher than these companies' actual borrowing rates would be." 65 Fed. Reg. at 14051. We therefore question the legitimacy of recommending an increased return on investment during the present period of historically low interest rates.

Joint Operating Agreements

The MMS proposes to change the presumption that Joint Operating Agreements are non-arm's length sales to a presumption that they represent arm's length sales transactions. This proposed change should be rejected, as it creates an opportunity for lessees to avoid paying royalties on value actually received for federal production.

In conclusion, we return to MMS' representation that: "Experience thus far has shown that the 2000 rules have generally served both MMS (and the states who cooperate with MMS in auditing Federal leases) and the producing industry well." We agree wholeheartedly. For that reason, the State of Wyoming cannot support those proposed changes which, as illustrated above, unjustifiably re-label deductions or permit cumulative deductions in a manner that diminishes the inherent value of the royalty interest, and are projected to generate a loss in royalty revenues to the state, federal, and local governments.

Best Regards,

Dave Freudenthal
Governor

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